feature article

A Guide to Global Transfer Pricing Strategy

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Global transfer pricing strategy involves an analytical approach that lets a business control its income tax cost on a worldwide basis. However, global transfer pricing is a complex topic. The author unravels these mysteries and guides the reader in negotiating the many twists and turns.

Income tax payments are a significant cost for most multinational businesses, and transactions between affiliated entities are an important part of this income tax exposure. Global transfer pricing is an analytical approach that enables a business to control its income tax cost on a worldwide basis. Global transfer pricing focuses only on transactions with related parties, so that relationships with independent entities are ignored. Other relationships, such as business partnerships between unrelated entities, remain a threshold inquiry for the tax collectors. Most recently, the Organisation for Economic Cooperation and Development (OECD) has turned its attention to transfer pricing in the context of Internet transactions.

A STANDARD APPROACH?

More than 30 countries have somewhat standard approaches toward transfer pricing: Argentina, Australia, Belgium, Brazil, Canada, Chile, China, Czech Republic, Denmark, Finland, France, Germany, Indonesia, Italy, Japan, Kazakhstan, Malaysia, Mexico, Netherlands, New Zealand, Poland, Russia, Sweden, Singapore, Switzerland, South Africa, South Korea, Spain, United Kingdom, United States, and Venezuela.

Global transfer pricing is complex and requires significant analytical inputs. A company seeking to use global transfer pricing should be able to answer the ten inquiries listed below for each country in which the company does significant business:

1. What transfer-pricing methods are acceptable in the country?
2. What priority is there among transfer-pricing methods?
3. What penalties can the country impose on your company?
4. When can you reduce the penalty that would otherwise be imposed?
5. What type of information must you provide to the tax collector?
6. Can you set up a pricing agreement with the tax collector in advance?
7. What adjustments and set-offs are required after a pricing adjustment?
8. When can you use a cost-sharing agreement with your affiliates?
9. What is the effective tax rate for your configuration in that country?
10. What is the effective withholding rate for international payments?

Transfer-pricing issues affect both the businesses that may have to pay the taxes and the tax collectors that expect to collect the taxes. Quite fortuitously and by design, transfer-pricing rules that cross international borders are much more similar than they are different. Most differences typically lead to double taxation, but these differences occasionally lead to tax saving opportunities.

TRANSFER-PRICING METHODOLOGIES

Governments most typically make their transfer-pricing analysis on a legal-entity basis so that transfer pricing focuses primarily on the legal ownership and control of legal entities. Very little attention is paid to branches or divisions from a transfer-pricing perspective. The tax collector may examine contractual relationships, corporate partnerships, and other activities.

Transfer pricing, for tax purposes, depends on pricing in and of itself, or on a split of net income among affiliated entities. Thus, transfer pricing has two often conflicting objectives: (1) determining an equitable share of the profits between taxing jurisdictions and (2) determining equitable prices for intercompany transactions.

Most countries focus on the pricing or transactional approach rather than a profit-split approach. Global trading is used for financial institutions.

The "standard" transfer-pricing methods include the following:

1. Comparable uncontrolled price method
2. Resale price method
3. Cost-plus method
4. Profit split

Countries do differ in their pricing methods, especially when it comes to the profit-split alternative. There are many variations and cost accounting methods in determining "cost." Value-based costing comes into play in determining the "plus." Brazil's transfer-pricing methods differ most significantly from the other countries.

Some countries impose a priority in determining the applicable transfer-pricing method. Other countries, including the United States, impose no specific priority. Their goal is to determine the best transfer-pricing method, using as part of a comparability analysis such parameters as the following:

1. Functions of the business in each country; activity-based costing has an important role here.
2. Contract terms, including purchasing terms, licensing, and so forth.
3. Risks, including everything from bankruptcy to currency devaluation to slip-and-fall.
4. Economic conditions, including riots, hyperinflation, tax incentives, and the like.
5. Property or services in each country.

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U.S. TRANSFER PRICING

In practice, transfer pricing in the United States is based on the comparable-profits method (CPM), which focuses on the U.S. activities of the business. This approach seeks comparative data between enterprises in the United States that ostensibly are similarly situated. Three comparable-profits methods are in widespread use:

1. The ratio of operating profits to sales
2. The ratio of gross profits to sales
3. The ratio of operating profits to operating assets

A number of adjustments are made to establish the CPM. These adjustments include the following:

1. Inventory adjustments
2. Accounts receivable
3. Accounts payable
4. Foreign-exchange risk

The taxpayer or the IRS frequently applies the easiest transfer-pricing method, which is often the formulary CPM. The taxpayer or the IRS auditor often applies the CPM procedure by going to the Standard Industrial Classification (SIC) code and doing the following:

1. Using the four-digit SIC code applicable to the business
2. Including other businesses in that SIC code
3. Preparing and utilizing CPM comparative formulas

At the present time, the SIC approach for transfer pricing is being abused and is fraught with difficulty. Here are the most serious transfer-pricing problems for the taxpayer or the IRS examiner:

1. The initial selection of SIC may be determined by a staff person in the company who is unfamiliar with the ramifications of SIC selection or with transfer pricing.
2. Such an individual may not be adequately familiar with the operations of the business to adequately select the SIC code.

3. A four-digit SIC code is too broad-based and encompasses activities vastly different from the taxpayer under examination.
4. The SIC process does not adequately affect changes in the taxpayer's business. Many businesses continue to use the SIC code by habit rather than by further analysis.
5. The SIC process does not contain an established process for changing a business's SIC code.
6. The SIC code may become obsolete as high technology rapidly changes. Multiyear data would not be available under any event.

A taxpayer can avoid a detailed transfer-pricing audit by preparing and retaining primary documents and background documents. The documents must be prepared in the ordinary course of business and cannot be prepared specifically for audit. Contemporaneous documentation includes the following:

1. Business overview
2. Organizational structure
3. Section 482 documentation
4. Method selection
5. Rejected methods
6. Controlled transactions
7. Comparables
8. General index

PENALTIES

The United States has a complex transfer-pricing penalty regime that is separate from penalties that could apply to taxpayers in other contexts and from the special penalty rules that could apply to foreign-owned U.S. corporations. These penalties are not deductible in determining gross income. There are, in fact, two transfer-pricing penalties: the transaction penalty and the net adjustment penalty.

There are two penalty levels: the substantial valuation misstatement penalty (20 percent) and the gross valuation misstatement penalty (40 percent).

All penalties apply to Section 482–related tax underpayments. Each type of penalty can apply at either of the two levels mentioned above. The penalty applies to the tax, not to underpayment itself. "Tax underpayment" is the difference between the result reflected on the tax return and the results as finally determined.

The United States has a complex transfer-pricing penalty regime…

The substantial valuation misstatement penalty applies if the price stated is twice as much as the true price or is half as much as true price. Consider the two examples:

1. The parties select an intercompany price of $4,000. The true price was $8,000. The 20 percent substantial valuation misstatement penalty applies to the difference.
2. The parties select an intercompany price of $4,000 The true price was $2,000. The 20 percent substantial valuation misstatement penalty applies to the difference.

The gross valuation misstatement penalty applies if price stated is four times as much as the true price or is one quarter as much as true price. Consider the two examples:

1. The parties select an intercompany price of $4,000. The true price was $16,000. The 40 percent gross valuation misstatement penalty applies to the difference.
2. The parties select an intercompany price of $4000 The true price was $1,000. The 40 percent gross valuation misstatement penalty applies to the difference.

The net adjustment penalty is the most significant of the two transfer-pricing penalties, especially for large and medium-sized multinationals. In contrast to the transactional penalty, which is determined on a transaction-by-transaction basis, the net adjustment penalty is determined on an aggregate basis. There are two levels in applying the net adjustment penalty: the substantial valuation misstatement penalty and the gross misstatement penalty.

The substantial valuation misstatement applies to the net adjustment penalty if the net Section 482 adjustment is less than $5 million or 10 percent of gross receipts. The substantial valuation misstatement net adjustment penalty could be recharacterized in the following manner:

1. Gross receipts of less than $50 million—valuation based on 10 percent of gross receipts
2. Gross receipts of $50 million—valuation of $5 million

3. Gross receipts of more than $50 million—valuation of $5 million

The gross valuation misstatement applies to the net adjustment penalty if the net Section 482 adjustment is less than $20 million or 20 percent of gross receipts. The gross valuation misstatement net adjustment penalty could be recharacterized in the following manner:

1. Gross receipts of less than $100 million—valuation based on 20 percent of gross receipts
2. Gross receipts of $100 million—valuation of $20 million
3. Gross receipts of more than $100 million—valuation of $20 million

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FOREIGN-OWNED BUSINESSES DOING BUSINESS IN THE UNITED STATES

Foreign-owned U.S. companies that are doing business in the United States could be subject to two U.S. tax regimes. The business has a dual tax responsibility if the business is engaged in intercompany transactions, and if a principal shareholder of the business is foreign.

The two U.S. tax regimes include (1) transfer pricing and (2) foreign-owned U.S. corporation reporting and record keeping.

These two regimes have different objectives, and, as such, interrelate on specified occasions.

The U.S. tax law imposes extensive responsibilities on foreign-owned U.S. corporations. The U.S. tax law also imposes responsibilities on the foreign owners, but these responsibilities are only derivative—i.e., the responsibilities relate the parent-subsidiary relationship—and limited in scope. This peculiar relationship toward the foreign owners exists because the United States recognizes that the long arm of the U.S. tax law is limited by international law concepts and does not apply directly to the foreign owners. The full responsibility falls on the U.S. subsidiary because the U.S. courts have power over this subsidiary as a result of its presence in the United States.

Foreign-owned U.S. corporations have two responsibilities: (1) to prepare and retain specified records and (2) to file specified documents with the IRS.

The foreign-owned U.S. corporation provisions may potentially have the following effects on the U.S. company:

1. May cause the U.S. company to be subject to penalties
2. May require the U.S. company to enter into an authorization agreement with the foreign owners
3. May subject the U.S. company to a summons
4. May subject the U.S. company to special harsh penalties for noncompliance

Foreign-owned U.S. corporations must file Form 5472 on an annual basis to reflect intercompany transactions with *each* affiliate. For example, a foreign-owned business has four subsidiaries overseas and three subsidiaries in the United States. Assume that each entity in the United States does business with the four subsidiaries of the parent and the parent itself. Each U.S. entity would have to file 5 copies of Form 5472. Since there are three U.S. subsidiaries, 15 copies of Form 5472 would be needed in all.

The term "U.S. owner" is broader than the ownership and control of a subsidiary. In fact, the tax rules require that the U.S. company reflect a shareholding of 25 percent or more. The relevant term is a "reporting corporation." Partnerships and branches are treated in the same manner as branches.

Form 5472 must reflect U.S. dollars, even if the principal currency was not the U.S. dollar. U.S. currency tax rules are used to determine the U.S. tax amount. Nevertheless, Form 5472 is an information return, not a tax return. Section 6038A permits the reporting corporation to use approximations. Estimates are considered reasonable if the estimates range between 75 percent and 125 percent of the actual amount. The IRS and the courts determine this actual amount.

The English language must be used for all purposes in preparing documents and filing the requisite forms to the IRS. The businesses can use foreign language documents and retain documents overseas, but the business must be prepared to translate these documents into English and have these documents made available to the IRS. The reporting party and the foreign-related party can contest in court the amount and the extent of the documents sought by the IRS.

The IRS could request virtually every record that exists and

some records that do not exist. Instead of requiring all of these records, the Treasury Regulations enable the reporting corporation to prepare and retain 100 or so separate records. The Treasury calls this provision a "safe harbor" and a part of the contemporaneous documentation rules. Nevertheless, tax practitioners view this provision an "unsafe harbor." Preparing less than all of the documents may enable the IRS to expand rather than contract its investigation. The Section 6038A safe harbor provisions have no parallel in the Section 482 provisions. Section 482 has no safe harbors.

There are six components to the Section 6038A safe harbor provisions:

1. Original entry books and transaction records
2. Profit and loss statements
3. Pricing documents
4. Foreign country and third-party filings
5. Ownership and capital structure records
6. Records of loans, services, and other non-sale transactions

The reporting corporation is obligated to prepare and retain many types of records. In some cases, the reporting corporation has an obligation to create records if these records otherwise did not exist. This rule applies to original entry books and transaction records.

Original entry books and transaction records include the following:

1. General ledgers
2. Sales journals
3. Purchase order books
4. Cash receipts books; cash disbursement books
5. Bank statements; canceled checks
6. Workpapers
7. Purchase invoices; sales contracts

The U.S. tax rules require more reporting for big companies and for big transactions than they do for small businesses and for small transactions. There are six reporting levels in all, by

1. Type of transaction $50,000
2. Related-party gross payments $5,000,000
3. U.S. gross receipts $10,000,000
4. Gross receipts—penalty exclusion $20,000,000
5. Significant industry segments $25,000,000
6. High profit test $100,000,000

> *The specific rules for foreign-owned U.S. corporations contain three penalties: initial penalties, additional penalties, and noncompliance penalties.*

The specific rules for foreign-owned U.S. corporations contain three penalties: initial penalties, additional penalties, and noncompliance penalties. It is important to note that these specific penalties that could apply to foreign-owned U.S. corporations are separate from the penalties that could apply to Section 482 transfer pricing. As such, foreign-owned U.S. corporations that made transfer-pricing errors are subject to two penalty regimes. These penalties are not deductible in determining gross income.

The penalties for foreign-owned U.S. corporations are based on the number of copies of Form 5472 required to be filed, which for a typical large multinational can be more than 100 per year. If ten U.S. subsidiaries of the foreign parent have the requisite transactions with foreign subsidiaries, 100 copies of Form 5472 must be filed and $10,000 penalties could be assessed up to 100 times for such failures, for a total of $1 million in penalties. The initial penalties are imposed on an annual basis.

The IRS can impose an initial penalty on a reporting corporation that fails to comply with (1) the reporting requirements imposed by Section 6038A and (2) the record maintenance requirements imposed by Section 6038A.

The initial penalty is $10,000 and can be imposed for each such failure.

Nevertheless, the penalty does not apply to minor failures. Instead, the penalty is imposed if the information required is "substantially incomplete." Three specific failures invoke the initial penalty:

1. Failure to furnish the information return, Form 5472, within the time and manner prescribed by the regulations
2. Failure to maintain records under the record maintenance rules; or failure of another party to maintain records under the record maintenance rules
3. Failure to meet the requirements for records outside the United States within the requisite time period

Additional penalties can apply if the IRS notifies the

reporting corporation in writing that the reporting corporation has failed to meet its compliance obligation and this failure continues for 90 days. At that point, the additional penalty begins to apply. The additional penalty is $10,000 for each 30-day period. A fraction of the 30-day period is treated as the entire 30-day period.

More penalties can apply if the IRS requests the requisite tax information but the reporting corporation is not forthcoming in providing this information. In that situation, the IRS can deny all deductions claimed. In addition, criminal penalties may apply for the reporting corporation that fails to file a tax return or files a false or fraudulent tax return.

A reporting corporation might be able to escape from penalties if the reporting corporation can demonstrate the following:

1. The reporting corporation has reasonable cause for its actions or inaction;
2. The reporting corporation has substantially complied with the record-keeping and reporting obligations;
3. The reporting corporation has proven the facts and circumstances were such to deny the penalty;
4. The reporting corporation acted in good faith; and
5. The reporting corporation's failure was due to an honest misunderstanding.

ADVANCE PRICING AGREEMENTS

The United States has long advocated advance pricing agreements (APAs). Similar advanced agreements are available in more than 20 countries. There are two types of APAs: (1) unilateral APAs, between the taxpayer and the IRS, and (2) bilateral APAs, between the taxpayer and the IRS, the foreign taxpayer, and the foreign tax authorities.

The APA procedure in the United States involves the following steps:

1. One or more pre-filing conferences
2. Paying a fee for the APA
3. The request for an APA
4. An establishment of critical assumptions in the APA
5. The APA agreement itself
6. Preparation of annual report to the IRS describing APA activities
7. Audit-limiting activities
8. Record retention
9. Continuation of the APA
10. Cancellation of the APA

An analysis of global transfer pricing most often reduces income tax payments in one or more jurisdictions, making the entire effort invariably worthwhile for the business as a whole.

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